§ 1.963–5 Foreign corporations with variation in foreign tax rate because of distributions.

(a) *Limited application of section.* The rules of this section shall apply to a foreign corporation only if—

(1) Under the laws of a foreign country or possession of the United States the foreign income tax of the corporation for the taxable year depends upon the extent to which distributions are made by such corporation from its earnings and profits for the taxable year, so that the rate of such tax for the taxable year on income which is distributed differs from the rate of such tax for such year on the income which is not distributed, and

(2) The corporation—

(i) Is a single first-tier corporation, or

(ii) Is for the taxable year in a chain or group from which the United States shareholder receives a minimum distribution in respect of which the minimum overall tax burden is determined in accordance with paragraph (a)(1)(ii) of § 1.963–4.

(b) *Foreign income tax determined as though no distributions were made.* The foreign income tax on the pretax and predistribution earnings and profits of the foreign corporation for the taxable year shall (solely for the purpose of determining the effective foreign tax rate under paragraph (c) of § 1.963–2) be determined as if the foreign corporation made no distributions for the taxable year. However, notwithstanding the second sentence of paragraph (d)(1) of § 1.963–2, where the United States shareholder owns the stock (with respect to which the election under section 963 is made) in such corporation by reason of stock owned through a chain of ownership described in section 958(a) and the foreign income tax of such corporation for the taxable year decreases as distributions are made from its earnings and profits, the rule in the preceding sentence shall not apply if the electing United States shareholder does not actually receive for the taxable year its proportionate share of the earnings and profits which are actually distributed. In such case, the foreign income tax on pretax and predistribution earnings and profits shall be the actual foreign income tax of such corporation, computed on the basis of the distributions which are made. For example, assume that a second-tier foreign corporation in a chain has pretax and predistribution earnings of $100 for the taxable year and that foreign law imposes on such corporation a foreign income tax of 50 percent of the pretax earnings and profits minus dividends for such year and of 20 percent of such dividends. If the second-tier foreign corporation distributes $20 of earnings and profits to a first-tier foreign corporation which is part of the same chain, and if the first-tier corporation retains the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be the tax actually paid for the taxable year, that is, $44 (50 percent of $80 plus 20 percent of $20). If the first-tier foreign corporation distributes the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be $50 (50 percent of $100). For purposes of this paragraph, the principles of paragraph (b)(3) of § 1.963–4 shall apply.

(c) *Minimum distribution*—(1) *Single first-tier corporation.* A minimum distribution for a taxable year by a single first-tier corporation described in paragraph (a)(1) of this section shall be a distribution which is equal to—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of § 1.963–2 for such year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(2)(i) of § 1.963–2 but without the deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(2) *Corporation in a chain or group making a pro rata minimum distribution.* In case of a corporation described in paragraph (a)(2)(ii) of this section in a chain or group, such corporation's

share of a pro rata minimum distribution by the chain or group for the taxable year shall be—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of § 1.963–2 for the taxable year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(3) of § 1.963–2 but without the deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(3) *A chain or group making a distribution other than a pro rata minimum distribution.* If a chain or group contains one or more foreign corporations described in paragraph (a)(2)(ii) of this section and such chain or group makes a minimum distribution other than a pro rata minimum distribution for the taxable year, the amount of such minimum distribution to the electing United States shareholder shall be at least—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of § 1.963–2 for the taxable year by the consolidated earnings and profits of such chain or group with respect to such shareholder, as determined under paragraph (d)(3) of such section but without any deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by the foreign corporations in the chain or group by reason of distributing such amount, less such tax, for such taxable year.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Domestic corporation M directly owns 80 percent of the one class of stock of single first-tier corporation B, which for 1964 has $100 of pretax earnings and profits on which is imposed a foreign income tax of 40 percent of pretax earnings and profits minus dividends for the taxable year and of 20 percent of the amount of such dividends. Both corporations use the calendar year as the taxable year. The effective foreign tax rate applicable to B Corporation, as determined under paragraph (c) of § 1.963–2, is 40 percent, and the statutory percentage under paragraph (b) of § 1.963–2 for 1964 is 38 percent. Corporation M receives a minimum distribution for 1964 if it receives from B Corporation's earnings and profits for such year $22.80, that is, 80 percent of $28.50, the distribution which would be made if there were distributed that amount of earnings and profits which, together with the foreign income tax at the rate effectively applicable to pretax earnings and profits to which such distribution is attributable, equals 38 percent of $100. Such distribution may be determined by solving for "d" in the following formula:

$$
\begin{aligned}
&d=\$38-0.20d-0.40(\$38-d)\\
&d=\$38-0.20d-\$15.20+0.40d\\
&d=\$22.80+0.20d\\
0.80\ &d=\$22.80\\
&d=\$22.80/0.80\\
&d=\$28.50
\end{aligned}
$$

Example 2. Domestic corporation M directly owns 80 percent of the one class of stock of each of controlled foreign corporations A and B, which constitute a group and each of which for 1964 has pretax earnings and profits of $100. All corporations use the calendar year as the taxable year. Corporation A is subject to foreign income tax at a flat rate of 40 percent; and B Corporation is subject to a foreign income tax of 40 percent of $100 minus dividends for the taxable year and of 20 percent of the amount of such dividends. The effective foreign tax rate with respect to the group, as determined under paragraph (c) of § 1.963–2, is 40 percent, and the statutory percentage under paragraph (b) of § 1.963–2 for 1964 is 38 percent. Corporation B distributes $25 for 1964 toward a minimum distribution from the group which is not a pro rata minimum distribution. The minimum distribution by the group for 1964 with respect to M Corporation is determined as follows:

M Corporation's proportionate share of B Corporation's distribution (0.80×$25)	$20.00
Pretax and predistribution consolidated earnings and profits of the group (0.80×$200)	160.00
Statutory percentage of pretax and predistribution consolidated earnings and profits (0.33×$160)	60.80

Less: portion of such statutory percentage to which the $20 dividend received from B Corporation is attributable: Total dividend paid by B Corporation	25.00
Plus: Foreign income tax on B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable, letting "t" represent such tax:	
t=0.20 ($25)+0.40t.	
t=$5+0.40t.	
0.60t=$5.	
t=$5/0.60	8.33
B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable	33.33
M Corporation's proportionate share of B Corporation's pretax and predistribution earnings and profits to which the dividend is attributable (0.80×$33.33)	26.67
The statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which A Corporation's distribution must be attributable	34.13
Dividend required to be received from A Corporation ($34.13 − [0.40×$34.13])	20.48
Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20+$20.48)	40.48

Example 3. The facts are the same as in example 2 except that the $25 distribution of earnings and profits is made by A Corporation. The amount of the minimum distribution for 1964 is determined as follows:

M Corporation's proportionate share of A Corporation's distribution (0.80×$25)	$20.00
Pretax and predistribution consolidated earnings and profits of the group (0.80×$200)	160.00
Statutory percentage of pretax and predistribution consolidated earnings and profits (0.38×$160)	60.80
Less: Portion of such statutory percentage to which the $20 dividend received from A Corporation is attributable: Total dividend paid by A Corporation	25.00
Plus: Foreign income tax on A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable (0.40×[$25/0.60])	16.67
A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable	41.67
M Corporation's proportionate share of A Corporation's pretax and predistribution earnings and profits to which dividend is attributable ($41.67×0.80)	33.34
Portion of the statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which B Corporation's distribution must be attributable	27.46
Dividend received from B Corporation, letting "d" represent the dividend:	
d=$27.46 − 0.20d − 0.40 ($27.46 − d).	
d=$27.46 − 0.20d − $10.98+0.40d.	
d=$16.48+0.20d.	
0.80d=$16.48.	
d=$16.48/0.80	20.60
Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20+$20.60)	40.60

(d) *Distributions through a chain or group.* In the application of paragraph (b)(3)(i) of §1.963–4, relating to the allocation of dividend payments first to income received as a distribution from other foreign corporations in the chain or group, if one or more of such other foreign corporations is a corporation whose foreign income tax rate decreases as the distributions are made, the allocation under such paragraph shall be made first to such corporations' distributions.

(e) *Foreign tax credit*—(1) *Year of minimum distribution.* If a United States shareholder receives for a taxable year a distribution of the earnings and profits for the taxable year of a foreign corporation described in paragraph (a) of this section and if for such year such corporation is a first-tier corporation, or a second-tier corporation described in section 902 (a) or (b), as the case may be, then, in applying paragraph (c)(2)(i) of §1.963–4, only the foreign income tax which is effectively applicable to pretax earnings and profits to which are attributable the earnings and profits which are distributed shall be deemed paid for such year under section 902 (a) or (b), as the case may be, and the foreign income tax so paid or accrued by such corporation shall not be averaged, for purposes of such section, with its foreign income tax paid or accrued for such year on its pretax earnings and profits to which are attributable the earnings and profits which are not distributed.

(2) *Year of distribution of remaining earnings and profits.* If for a taxable year a United States shareholder receives a minimum distribution from a corporation described in paragraph (a) of this section, the pretax and predistribution earnings and profits of such corporation for the taxable year to which such minimum distribution is attributable and the foreign income tax which is taken into account, in accordance with paragraph (c)(2)(i) of §1.963–4, in determining tax deemed paid under section 902 on such pretax and predistribution earnings and profits shall not be taken into account in the application of section 902 when

other earnings and profits of such foreign corporation for such year are distributed in a subsequent taxable year of such foreign corporation to such shareholder.

(3) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example 1. (a) All the income of controlled foreign corporation B, wholly owned directly by domestic corporation M, is taxed by foreign country Y, the tax laws of which impose at the local level a corporate income tax of 10 percent of earnings and profits (before reduction for income taxes) and, at the national level, an income tax of 30 percent of such earnings and profits reduced by the local tax and by any profits which are distributed. Also, at the national level, a tax of 20 percent is imposed on B Corporation on the dividends which are paid for the taxable year. Both corporations use the calendar year as the taxable year. For 1963, B Corporation has earnings and profits (before reduction by income taxes) of $100. B Corporation is not a less developed country corporation under section 902(d). For 1963, M Corporation makes a first-tier election with respect to B Corporation and receives a minimum distribution. Corporation B has no 1964 earnings and profits, and its remaining 1963 earnings and profits are distributed late in 1964. The amount of the minimum distribution required to be received by M Corporation for 1963 and the United States tax with respect to the 1963 earnings and profits of B Corporation are determined as follows, assuming a United States corporate income tax rate of 52 percent (instead of 50 percent) for 1964 and no surtax exemption under section 11(c) for either year:

1963

Effective foreign tax rate which obtains if no earnings and profits of B Corporation are distributed [($100×0.10)+([$100 − ($100×0.10)]×0.30)]/$100	37%
Minimum percentage of earnings and profits required under section 963(b) to be distributed, given a 37 percent effective foreign tax rate	68%
Amount of earnings and profits (before reduction by foreign income tax) to which minimum distribution would be attributable if the effective foreign tax rate of 37 percent obtained (0.68×$100)	$68.00
Minimum distribution required to be received by M Corporation, i.e., such an amount that is $68 less the foreign income tax on such $68, determined by letting "d" equal the dividend in the algebraic equation:	
d=$68 − (0.10 × $68) − 0.30 ($68 − [0.10 × $68] − d) − 0.20d.	
d=$68 − $6.80 − ($20.40 − $2.04 − 0.30d) − 0.20d.	
d=$61.20 − $20.40 + $2.04 + 0.30d − 0.20d.	
d=$42.84 + 0.10d.	
0.90d=$42.84.	
d=$42.84/0.90, or	$47.60
Gross-up under section 78, using the actual foreign income tax imposed on pretax profits to which are attributable the earnings and profits distributed ($6.80+0.30 [$61.20 − $47.60]+0.20 [$47.60])	$20.40
Taxable income of M Corporation for 1963 ($47.60+$20.40)	$68.00
U.S. tax before foreign tax credit ($68×0.52)	$35.36
Foreign tax credit ($47.60/$47.60× $20.40)	$20.40
U.S. tax payable for 1963 ($35.36 − $20.40)	$14.96
Overall U.S. and foreign income tax rate [$14.96+$20.40+($32×0.37)]/ $100	47.20%

1964

Dividend received by M Corporation ($32 − [0.37×$32])	$20.16
Gross-up under section 78, using the foreign income tax paid or accrued on pretax earnings and profits to which are attributable 1963 earnings and profits distributed during 1964 ($20.16/$20.16×[$32× 0.37])	$11.84
Taxable income of M Corporation for 1964 ($20.16+$11.84)	$32.00
U.S. tax before foreign tax credit ($32×0.52)	$16.64
Foreign tax credit ($20.16/$20.16× $11.84)	$11.84
U.S. tax payable ($16.64 − $11.84)	$4.80

(b) If B Corporation were a less developed country corporation under section 902(d), there would be no gross-up under section 78 and the foreign tax credit of M Corporation would be $14.28 for 1963 ($47.60/[47.60+ $20.40]×$20.40), and $7.46 for 1964 ($20.16/ [$20.16+$11.84]×$11.84).

Example 2. For 1963, domestic corporation M receives a dividend of $21 from B Corporation which counts toward a minimum distribution from a group, determined by applying the special rules of paragraphs (b) and (c) of §1.963–4. Both corporations use the calendar year as the taxable year. Foreign law imposes on B Corporation an income tax of 40 percent of the year's pretax earnings and profits, less dividends paid for such year, and of 20 percent of such dividends. Corporation M directly owns 70 percent of the one class of stock of B Corporation, which for 1963 has pretax and predistribution earnings and profits of $100. Corporation B is not a less developed country corporation under section 902(d). In late 1964, M Corporation receives a distribution of all of B Corporation's 1964 earnings and profits and of $25.20 from its 1963 earnings and profits. The foreign income tax of B Corporation deemed paid for 1963 by M Corporation under section 902(a) is based on the foreign income tax actually paid by B Corporation on an amount of pretax earnings and profits which, when reduced by the tax so paid, equals the total dividend which is paid. The determination of tax deemed paid by M Corporation with respect to distributions from 1963 earnings and profits of B Corporation is as follows:

1963	
Pretax and predistribution earnings and profits of B Corporation for 1963	$100
Total dividend paid by B Corporation in 1963 ($21/0.70)	30
Total foreign income tax paid by B Corporation for 1963 (0.40[$100 − $30]+[0.20×$30]) or ($28+$6)	34
Foreign income tax, represented by "t" in the following equation, to be taken into account with respect to total dividend in determining tax deemed paid under section 902(a) by M Corporation:	
t=(0.20×$30)+0.40t.	
t=$6+0.40t.	
0.60t=$6.	
t=$6/0.60, or	$10
Foreign income tax deemed paid by M Corporation for 1963 ($21/$30×$10)	7
1964	
Remaining 1963 earnings and profits of B Corporation ([$100 − $34] − $30) or ($66 − $30)	36
Dividend received by M Corporation for 1964 (0.70×$36)	25.20
Foreign income tax deemed paid by M Corporation for 1964 ($25.20/$36× [$34 − $10]) or ($25.20/$36×$24)	16.80

[T.D. 6759, 29 Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964]

§ 1.963–6 Deficiency distribution.

(a) *In general.* Section 963(e)(2) and this section provide a method under which, by virtue of a deficiency distribution, a United States shareholder may be relieved from the payment of a deficiency in tax for any taxable year arising by reason of failure to include subpart F income in gross income under section 951(a)(1)(A)(i), when it has been determined that such shareholder has failed to receive a minimum distribution for such year in respect of which it elected to secure the exclusion under section 963. In addition, this section provides rules with respect to a credit or refund of part or all of any such deficiency which has been paid. Under the method provided, the benefit of the exclusion of subpart F income from gross income of the United States shareholder is allowed retroactively for the taxable year in respect of which the election under section 963 applied, but only if the subsequent deficiency distribution meets the requirements of this section. The benefits of the retroactive exclusion will not, however, prevent the assessment of interest, additional amounts, and assessable penalties.

(b) *Requirements for deficiency distribution*—(1) *Distribution made on or after date of determination.* If—

(i) A United States shareholder, in making its return of the tax imposed by chapter 1 of the Code for any taxable year, elects to secure an exclusion under section 963 for such year,

(ii) It is subsequently determined (within the meaning of paragraph (c) of this section) that an exclusion under section 963 of subpart F income with respect to stock to which such election relates does not apply for such taxable year because of the failure of such shareholder to receive a minimum distribution for such year with respect to such stock, and

(iii) Such failure is due to reasonable cause, a deficiency distribution which is received by such shareholder with respect to such stock from a foreign corporation which was the single first-tier corporation, or a corporation in the chain or group, as the case may be, with respect to which the election was made, shall count toward a minimum distribution under section 963 for such year of election if such deficiency distribution is received (except as provided by subparagraph (2) of this paragraph) on, or within 90 days after, the date of such determination and prior to the filing of a claim under paragraph (d)(1) of this section. Such claim must be filed within 120 days after the date of such determination, and the deficiency distribution must be a dividend of such a nature (except as otherwise provided in this section) as would have permitted it to count toward a minimum distribution for the taxable year of the election if it had been received by the United States shareholder during such year. No distribution shall count as a deficiency distribution under this subparagraph unless a claim therefor is filed under paragraph (d)(1) of this section.

(2) *Distribution made before date of determination.* A deficiency distribution may also be received by a United States shareholder at any time prior to the date on which the determination required by subparagraph (1) of this paragraph is made. A distribution will